both the monopoly and competitive segments, which are also assumed to be efficient, it forces entrants to absorb those costs

The DCS critique points out that it is virtually impossible to assume the current status of the industry is optimally efficient, since these are monopoly inputs and shared and overhead costs which have never been subject to competitive pressures and over which companies have resisted regulatory oversight. The rate of profit earned on and the resources used to produce the direct, shared and overhead costs are all the result of decisions not disciplined by market forces and imperfectly policed by regulators.

As has been seen in the quotes cited above, the LECs insist that since current rates are prudent, they must be defended with an opportunity to recover costs. The prudence of regulated rates and the efficiency of output in a competitive market are not necessarily the same. The presumption, implicit in the move to local competition, is that a competitive marketplace will produce the more efficient outcome. Thus, the decision about pricing monopoly inputs poses the difficult issue of ratifying all current overhead, common and shared costs or exposing them to competition. ECP is oriented toward static efficiency and preserving the status quo of incumbent, shielding the largest share of costs possible from competition and imposing the highest barrier to entry. By embedding the shared and overhead costs in the price for monopoly elements, the entrant is saddled with all of the profits and potential inefficiencies of the incumbent. The incumbent lacks any incentive to lower the overhead and shared costs, since reductions will be passed through to entrants. The only manner in which entrants can avoid these costs is to replicate the entire monopoly element, which reproduces the initial barrier to entry.

DCS is dynamic, exposing the largest body of costs to competition and minimizing the barriers to entry by forcing the shared and overhead costs to be recovered at retail. If the shared and overhead costs of the incumbent are less than those of the entrant, then the incumbent will prevail.

To the extent that both firms have overhead and common costs, then they will be on an equal footing with respect to what they can recover at retail. Since the entrants cannot recover any of their overhead and common costs on the sale of monopoly functions, the two firms are competing on equal grounds. On the other hand, it is possible that overhead and common costs are larger in a firm selling a wider range of services (and it is still impossible to attribute common costs to specific services).

2. Competition

ECP maximizes the ability of incumbents to engage in anti-competitive allocation of costs, by incorporating excess profits and misdefined costs into overhead and shared costs, which entrants can only avoid by total facilities entry. Incumbents invariably ask for an additional public policy of pricing flexibility, which interacts strongly with ECP to undermine the introduction of competition. Incumbents will seek pricing flexibility to respond to entrants, which allows them to squeeze the entrants who have been saddled with shared and overhead costs. They forego "contribution" in their own prices to prevent loss of market share, but they pass the imputation standard, which is typically set at direct costs only.

DCS allows full pricing flexibility, but eliminates potential for price squeeze and forces recovery of contribution at retail. It minimizes the ability of incumbents to engage in anti-competitive allocation of costs.

ECP sends the wrong signals on facilities deployment and increases the potential problem of stranded investment. It induces the potential entrants to deploy facilities against the combination of direct, shared and overhead costs, potentially substituting direct costs for savings on shared and overhead costs. Incumbents invariably link ECP to claims for recovery of stranded investment should entrants decide to replace monopoly elements. This problem is compounded by the artificial inducement to enter facilities-based competition.

DCS avoids the over investment in facilities. However, TSLRIC pricing raises the question of underinvestment in facilities by incumbents. To the extent that functionalities are likely to remain monopoly in the long term and overhead, shared and common costs cannot be recovered at retail, incumbents will be dissuaded from deploying facilities which provide monopoly services that do not help recover overhead, common and shared costs.

ECP appears to have a multi-product problem. Since incumbents will recover all shared and overhead costs on any remaining monopoly element, entrants have no incentive to break the monopoly element down into pieces. It makes little sense to find a way to buy half the monopoly element because as long as they are captive at any point, the incumbent will recover all shared and overhead costs. This raises the barrier to entry and undermines efficiency.

DCS encourages actions to whittle away at monopoly elements.

CFA and CU believe that overall, as a policy for promoting competition, DCS is more efficient and certain to be more dynamic because it:

1. Drives monopoly functions to social costs.
2. Maximizes costs subject to competition.
3. Induces efficient long term facilities entry.

4. Minimizes ability to price anti-competitively.

5. Minimizes regulatory burden.

6. Minimizes stranded investment costs.

7. Balances interests of incumbents and entrants by allowing a fair return on monopoly investments and a market opportunity to recover shared costs and overheads at retail.

CFA and CU also recognize, however, that DCS is not without its own shortcomings.

1. To the extent that there are legitimate overhead cost differences between firms providing different ranges of services and incumbents are unable to recover those differences at retail, they will be at a disadvantage -- entrants get the use of network elements without a fair share of common costs.

2. The absence of a mark-up on products for long periods of time is not a typical way for firms to do business.

3. The lack of a mark-up may result in a disincentive to invest in facilities that provide services which do not contribute to the support of overhead, common and shared costs.

4. Some of the infirmities of ECP can be corrected with policies other than DCS.

D. CFA AND CU ADVOCATE A BALANCED MIDDLE COURSE ON MARK-UPS

Because local telephone service has been a monopoly for over three quarters of a century, the incumbent local telephone companies have a practically insurmountable head start on any potential competitor in the form of a line into every residence and business in the country and a switching network that connects them all. With this vast amount of capital dedicated to local service deployed behind the wall of monopoly protection over decades and control over a ubiquitous network, it is impossible to require individual companies to build their own networks to get into the local telephone business.

If policymakers intend to create competition in local exchange service, then their central

task is to ensure that the network opens its doors and allow competitors to set up business. The only way competition can get started is to be ensured that all entrants can interconnect with the existing local network and have access to its monopoly elements in a way that gives them a chance to win customers.

If the need to interconnect were not inevitable and the monopoly network not so pervasive and entrenched, pricing monopoly components would be less important. Given the current network, however, if promoting competition is the goal, then this is **the** central issue.

The all or nothing character of the recovery of shared and overhead costs as embodied in the debate between advocates of ECP and DCS immediately invites speculation about the possibility that some formula in between might make more sense. The incumbents insist that regulated just and reasonable rates are, by "fiat," the correct rates (efficient, just and reasonable) and failure to allow recovery of shared and overhead costs violates the incumbents rights. Entrants insist that the monopoly elements are special commodities that would not be produced independently, but must be produced to further the public interest in a competitive telecommunications environment, deviation from direct costs has dire consequences for competition. It seems reasonable to suppose that most firms spread their mark-ups for shared and overhead costs across the full array of goods they sell. They also mark-up individual products differently to cover their shared and overhead costs.

CFA and CU believe certain core principles come readily to mind, however.

First, with respect to the economic costs of providing network functionalities on an unbundled or wholesale basis the following are critical to effective competition.

1. The cost methodology should be a bottoms-up methodology consistently applied to

the whole, as well as the parts (i.e. the same methodology should be applied for costing purposes at retail and wholesale, for the bundled and unbundled elements.

2. Start-up costs associated with the introduction of competition -- e.g. generic costs associated with competition, such as number portability or unbundling and wholesale of network functionalities -- should be recovered in a competitively neutral manner and not burden specific transactions.

3. Recurring costs associated with sale of monopoly functionalities should be recovered in the price of the services rendered.

Second, with respect to contribution, the following principles strike a balance between the two extremes.

4. Because these are monopoly elements, contribution should be no more than any contribution that is collected in basic service. For example, the rate of contribution within the residential class for basic service should be the limit of contribution collected in the rates of unbundled functionalities for his class of customers.

Third, with respect to the economic costs of providing network functionalities on an unbundled or wholesale basis the following are critical to effective competition.

5. Contribution should never occur on monopoly elements sold to competitors, where it does not occur at retail (i.e if there are subsidies these need to be "backed out" of unbundled prices.

6. To the extent that universal service funds are created to cover social costs, which are presently included in general contribution, contribution on monopoly elements should be reduced proportionately.

7. Contribution should be pro rata and fixed. Contribution should be proportionate to elements consumed and not allowed to be shifted to the last kernel of monopoly functionality. In the above example at p. 38 *supra*, if competitors find a way to buy half y, the contribution should be cut in half.

Fourth, with respect to imputation and pricing flexibility the key principle is consistency.

8. If there is any pricing flexibility, the best way to prevent anti-competitive abuse is to set rates without contribution

9. If pricing flexibility and contribution are both allowed, the imputation standard must be adjusted to reflect discounting, in order to prevent price squeezes.

10. The tariffed rates paid by competitors for network functionalities must be used to calculate the price floor for imputation purposes.

11. If discounts are offered at retail, similar discounts must be automatically passed through to purchasers of the discounted elements at wholesale or a price squeeze is certain.

Fifth, with respect to specific offerings there are two key principles.

12. The purchase of a functionality should allow the purchaser to sell all services associated with those functionalities in the LEC offering. If entrants are not allowed to sell at least the same set of services that the functionality enables LECs to sell, they will be placed at a disadvantage. This is the equivalent of a price squeeze, except it is a revenue squeeze.

13. Total wholesale resale tariffs for basic service should include the same level of basic service contribution as unbundled monopoly functionalities. In so doing, no competitive advantage is gained or lost, while the public policy goal of promoting universal service is preserved. Using the same rate for contribution for unbundled elements preserves competitive

neutrality between facilities based and wholesale tariffs.

VI.

PRICING INTERCONNECTION BETWEEN CARRIERS

Making network elements available to new entrants at rates that support competition is critical in the short and mid-terms to breaking down the local exchange monopoly, and it may be a necessary aspect of long term competition in some market segments that will not support duplicate networks. A compensation mechanism for traffic exchange plays an even more important, permanent role in determining the speed and quality of the growth of competition. The only way competition can get started is to be ensured that all entrants can interconnect with the existing local network and have access to its monopoly elements in a way that gives them a chance to win customers. If the need to interconnect were not inevitable and the monopoly network not so pervasive and entrenched, pricing monopoly components would be less important. Given the current network, however, if promoting competition is the goal, then this is the central issue. This section of our comments addresses the questions raised in para. 53-54 and 227-243 of the Notice regarding transport and termination of calls.

A. TWO APPROACHES TO COMPENSATION FOR INTERCONNECTION

A regime of mutual traffic exchange is attractive because it is the approach that has been used for local service for decades. Mutual traffic exchange entails local exchange carriers simply terminating local calls originated on the network of other local exchange carriers without charge. In a competitive environment, however, the ability to game such an approach requires that it be modified. Entrants may seek high volume customers and be the beneficiaries of large

imbalances in the exchange o services. As a result, they would incur much lower costs for terminating competitor calls than they impose on competitors.

On the other hand, a regime of reciprocal compensation may appear attractive because carriers pay for facilities used on other networks. Reciprocal compensation requires each local service provider to compensate every other service provider whose network is required to complete every call. In an interconnected network where there is mutual provision of identical functionalities, reciprocal compensation may be an unnecessary burden on commerce and provide the opportunity for anti-competitive pricing. It may also create unnecessary pressures for local measured service and shield incumbents from competitive pressures, by allowing them to recover excess costs from monopoly services.

B. USAGE BASED COMPENSATION

A usage-based compensation mechanism between local exchange carriers is uneconomic, anti-competitive and not in the public interest. The arguments against mutual traffic exchange are based on a faulty understanding of the nature of an interconnected network and faulty assumption about efficient cost recovery and cost causation. CFA and CU maintain that a compensation mechanism that incorporates principles of mutual traffic exchange to the greatest extent possible and avoids measurement based compensation will do much more to promote competition and preserve consumer choice in local exchange service.

1. Mutual Exchange and Efficiency of an Interconnected Network

Not only is the historic approach to compensation between local exchange carriers one

of mutual traffic exchange,[22] but this is the mechanism that appears to be emerging as the approach to compensation on information age networks, like the internet.[23] The mutual benefit of interconnected networks demand reciprocity in exchange. Rather than impose measurement, billing and financial transactions on the seamless exchange of bits, the internet has adopted the telecommunications approach of mutual traffic exchange.

2. Economic Efficiency and Cost-Based Rates for Termination of Local Calls

The LECs and others claim that only by charging cost-based rates for termination will efficiency be promoted.

> Bill and Keep does not reflect underlying costs of the respective networks, allowing for the subsidy of one carrier by another and also for economically inefficient entry.[24]

> In a competitive environment, it is contrary to sound public policy to deny compensation to a terminating carrier that incurs costs on behalf of an originating carrier. No party, including the new entrants has denied that companies incur costs to terminate calls. If rate structures or compensation arrangements are established that are obviously at odds with economic causation (such as bill and keep), they become a source of subsidy and an invitation to arbitrage.[25]

This argument misses the fundamental point that termination of local calls is not a service being sold separately in a competitive marketplace. It is bundled in with local exchange service. At the outset, the availability of termination for new entrants is a monopoly enjoyed by the incumbents as a legacy of its historic monopoly. The cost-based rates that would be charged are

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[22]Ohio Competition Proceeding, Comments of Time Warner, p. 13.

[23]Gerald W. Brock, The Economics of Interconnection (Teleport Communications Group, April 1995, p. 1.

[24]Ohio Competition Proceeding, Department of Defense, p. 7.

[25]Ohio Competition Proceeding, Ameritech, p. 35.

simply the old costs of the monopolist.

The claim that each firm should be allowed to recover its costs, whatever they are and whether or not there is competition for termination, does not comport with the behavior of a competitive marketplace. In a competitive market, firms would only be able to charge the market clearing price (the price at which the last unit of demand is satisfied). If their costs are above that price, they must absorb lower than average rates of return. Over time they would have to lower their costs.

By allowing LECs to charge cost-based rates, without effective competition, inefficient firms are supported by the marketplace. To the extent that this approach to cost-based pricing allows inefficient service providers to survive in the marketplace, they are the beneficiaries of a subsidy through a breakdown of competition.

In fact, mutual exchange avoids this subsidy. Mutual exchange allows parties to compensate one-another at the level of functionalities. Each firm receives exactly what it gives, the termination of a call. To the extent that one firm is inefficient at terminating calls, it will find that its competitors can price their local service more attractively to end users (or it must endure lower than average profits). Since termination of calls is bundled with local service, the fact that differences in cost that result from mutual exchange are reflected at the level of overall prices or profits is appropriate.

3. Usage-Based Rates, Economic Efficiency, and Cost Causation

LECs and others argue that cost-based rates must by recovered in usage-based charges, generally modeled after access charges.[26] This argument is questionable at best. Charging for

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[26]Ohio Competition Proceeding, e.g. Ameritech, p. 37; Department of Defense, p. 7.

interconnection on a usage basis is wasteful and unnecessary, as has been made clear in Ohio and a number of other states.

Cost causation for termination is not simply usage-sensitive, rather it is driven by peak usage.

> It is inconsistent with the manner in which costs are incurred, since costs are driven by peak capacity.[27]

Usage-based compensation also imposes inefficiencies and administrative costs.

> It creates economic inefficiencies by imposing unnecessary costs of measurement and creating incentives to ask for excess capacity.[28]

> It imposes substantial, unnecessary administrative costs,[29] creates additional regulatory costs to monitor imputation[30] and prevent arbitrage.[31] Usage-based pricing for interconnection will also frustrate efforts to promote competition.[32]

4. Assumptions about Exploitative Behavior

The LECs and others make a variety of arguments about how new entrants will abuse mutual compensation mechanisms by shifting costs onto LECs through selective marketing (of high outgoing only customers) or even designing outgoing only service.[33] They further assert

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[27]Ohio Competition Proceeding, TCG, p. 19.

[28]Ohio Competition Proceeding, United/Sprint, Answers, p. 14.

[29]Ohio Competition Proceeding, Time Warner, Response to Questions, p. 5, TCG, p. 19, United/Sprint, p. 24.

[30]Ohio Competition Proceeding, Time Warner, Comment, p. 8.

[31]Ohio Competition Proceeding, United/Sprint, p. 14.

[32]Ohio Competition Proceeding, Time Warner, Answers, p. 5; TCG, Appendix.

[33]Ohio Competition Proceeding, Ameritech, p. 37.

that entrants will create inefficient demand for interconnection.[34]

These arguments are unfounded. Inequality of traffic exchange over a sustained period has not been documented. At present, the primary incentive to remaining with the incumbent for purposes of heavy incoming usage is the lack of number portability. The familiarity of numbers and the inferiority of interim number portability predispose high volume users to incumbents. Once this barrier to competition is removed, there is no reason to believe that there will be a substantial incentive to seek heavy outgoing only customers.

5. Interconnection Charges and Competition

The LECs ignore the impact that usage-based interconnection charges would have on consumer sovereignty. Imposing usage-based charges with incumbents passing along their costs, plus contribution, would set a high floor on competitive offerings.

> Allowing LECs to charge for termination of calls sets a floor price on competitors that restricts their ability to compete, while protecting the inefficiencies of the incumbents.[35]

> Usage-based pricing also makes it difficult for competitors to market flat rate service or to try innovative approaches to pricing services.[36]

Thus, usage-based pricing places severe constraints on the marketing potential for entrants.

D. POLICY RECOMMENDATIONS

In the integrated digital network toward which the interoffice telecommunications network

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[34]Ohio Competition Proceeding, Department of Defense, p. 7.

[35]Ohio Competition Proceeding, TCG, p. 18; United/Sprint, p. 24.

[36]Ohio Competition Proceeding, TCG, p. 14; United/sprint, p. 24.

has largely evolved, efficient routing of calls should take precedence, using the technically most efficient path to complete local calls.

1) The FCC should encourage the mutual exchange of traffic to the extent possible and modify that system as necessary to prevent gaming, anti-competitive behaviors, or uneconomic outcomes. In this approach companies exchange services (use of facilities) to the maximum extent possible and then settle up differences at reasonable compensation rates. Commissions should explore mutual traffic exchange, with studies to ascertain whether imbalances will occur in the long term.

2) To the extent that monetary transactions are necessary, they should be based only on imbalances. If usage-based rates are deemed necessary, then they should be applied only to imbalances.

3) Compensation should be at TSLRIC.

4) Reflecting the fact that termination is a monopoly function, if contribution to joint and common costs is allowed, it should be limited to a level similar to that of basic service, as applied to unbundled elements.

VII.

STRANDED INVESTMENT

With efficient component pricing the incumbents seek to maximize the recovery of joint and common costs by leveraging the remaining monopoly power possessed by the incumbent. Virtually all LECs go one step farther. Each of the local exchange companies has proposed what is tantamount to a Regulatory Indemnification Plan (R.I.P., for short, because it lays to rest any chance that ratepayers will receive a fair deal in the transition to competition). The fund indemnifies telephone company stockholders against any past, present or future risk for any asset currently on their books, and those future assets for which there is a possibility that market conditions will not cover cost

A. NO RISK INVESTMENT

1. Competitive Losses

The local exchange companies have reinterpreted their century old relationship with regulators and ratepayers as one in which they were guaranteed total recovery of all investments. In the following definition of stranded investment offered by Ameritech in Ohio, for example, it is evident the LECs envision a counter-factual ratemaking in which they will reconstruct what their business would have been like without competition and claim that every sale lost and every investment not fully utilized would have performed perfectly, but for the advent of competition. The Ohio competition proceeding provides a clear case in point.

> Stranded investment includes facilities that are no longer used to serve end users because such end users are being served by the facilities of competitors, as well

as excess capacity which was built to carry the traffic of other providers which is no longer needed because such providers are now utilizing their own facilities...

Some stranded investment may be identifiable by the presence of the competitors facilities now being used to serve the end user, substantiated by records of disconnection of service from the incumbent and establishment of service with the competitor. Other types of stranded investment, such as that associated with excess capacity no longer needed to carry competitors' traffic, can be substantiated by documentation as to changes over time as to percent utilization of incumbent's facilities, intercarrier arrangements (end office integration, tandem trunking), etc.[37]

ALLTEL's view of stranded investment is much the same.

Stranded plant is investment placed in service pursuant to regulatory requirements that becomes no longer used and useful as a result of the deployment of facilities by competitive providers.[38]

The presence of new competitors will generate stranded plant when the competitors install new technology that bypasses the existing facilities, or if the competitor duplicates existing facilities of the incumbent LEC.[39]

2. Retroactive Ratemaking and the Elimination of Risk

Some LECs also propose to take this opportunity to declare that all previous investments that have not proven successful were caused by social decisions for which it must now be made whole. They propose recovering the entirety of their depreciation reserve from telecommunications ratepayers because regulators used the wrong estimation of the "true" economic life of investments and the LEC only made those investments because it thought regulators had guaranteed they would all be paid off, which the company now asserts will not happen, due to the introduction of competition.

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[37]Ohio Competition Proceeding, Ameritech, Attachment 2, pp. 24-25... 27-28.

[38]Ohio Competition Proceeding, ALLTEL, p. 27.

[39]Ohio Competition Proceeding, ALLTEL, Attachment 1, p. 13.

This underrecovery of capital assets arises because under past regulation depreciation rates of capital investment were held artificially low compared to the true economic lives of the investment. The expectation was that the deferred amounts would be paid by future customers. With competition, the future customers are being served by other providers as well as Ameritech. Therefore, Ameritech's future (no current) customers should not bear the full burden of this temporal subsidy. Rather, the burden should borne equitably between the customers served by Ameritech and by the new providers. For Ameritech Ohio, on an intrastate basis, this represents approximately $460 M which it proposes to amortize over 7 years as follows...[40]

GTE's rendition of these matters is virtually identical.

Local exchange carriers' existing level of investment was incurred pursuant to their obligation under a social contract. The Commission had previously found this level of investment to be reasonable, prudent and necessary to provide an appropriate level of service. All such investment was incurred as a cost of doing business under rate base regulation, and companies are entitled to recover capital regardless of when plant is used. LECs will experience at least two problems in the recovery of this embedded investment.

First, there is currently a depreciation reserve deficiency created by depreciation rates which are not indicative of competitive operations. This underrecovery of capital must be totally returned.... Second, to the extent that LECs experience stranded plant due to competitive losses, they are also entitled to compensation for this investment previously deployed under the social contract.[41]

All embedded investments were incurred as a cost of doing business under a sole provider market structure with associated obligations and pricing constraints including rate base regulation. Accordingly, the Company is entitled to recover its capital, particularly underdepreciated capital, regardless of how the plant is idled.[42]

ALLTEL takes much the same position:

These carriers of last resort would be entitled to withdraw from the fund amounts equal to the sum of their respective rebalancing shortfall, depreciation reserve deficiency and unrecovered investment associated with stranded plant.

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[40]Ohio Competition Proceeding, Ameritech, Comments, p. 109.

[41]Ohio Competition Proceeding, GTE, Appendix C, p. 14.

[42]Ohio Competition Proceeding, GTE, Appendix C, p. 19.

> The depreciation reserve deficiency would be defined to be an amount equal to the difference between the book depreciation reserve level and the reserve level required to reflect the actual remaining life of embedded plant. This embedded plant was placed and depreciation was recorded under regulation. The approved depreciation rates applied to the investment were often set artificially low by regulators in order to keep service prices more affordable, resulting in today's level of reserve imbalances which must be recovered through explicit support in a competitive environment.[43]

The premise on which the indemnification plan is based lacks any empirical, regulatory or legal basis.

B. EMPIRICAL, THEORETICAL AND LEGAL FLAWS IN THE NO RISK ARGUMENT

The claims for by LECs for up front revenue replacement for lost opportunities and compensation for stranded investment through either the exercise of market power by overpricing remaining bottleneck facilities or through regulatory indemnification plans lacks any empirical, theoretical and legal justification.

1. Empirical Analysis Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

Contrary to the company arguments, there is no reason for the Commission to conclude that stranded investment currently exists. There is no reason to believe that every asset deployed by the companies was deployed to meet a social obligation. There is no reason to believe that the value of every asset which has not been fully depreciated when technology renders it obsolete was undermined by a social policy of underpricing. There is good reason to believe that the companies have already been substantially compensated for any risks of under recovery of the

[43]Ohio Competition Proceeding, Alltel, p. 27.

value of the assets they wish to declare stranded.

Contrary to the company arguments, there is no reason that the Commission should conclude that stranded investment will soon exist. There is no demonstration that assets will underperform and revenue deficiencies will develop as a result of regulatory changes. There is no demonstration that assets will underperform or that revenue deficiencies will develop as a result of whatever market changes take place.

Contrary to the company arguments, there is no reason that the Commission should conclude that, even if some investment is stranded, a new regulatory mechanism must be implemented to handle it. There is no demonstration of any company specific revenue deficiency in the aggregate. There is not even a demonstration of a revenue deficiency in the specific exchanges which are said to be creating the social obligation.

In the context of the federal legislation, it should also be recognized that there are important up-side opportunities for the LECs to enter new markets. Many of these markets can be served with the facilities that have been deployed to serve the local exchange market. For regulators to recognize only the down-side potential but not the up-side would bestow all the benefits on the companies while imposing all the costs on ratepayers.

2. Economic Theory Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

Contrary to incumbent LECs claims, allowing them the right to claim and recover "stranded" investment is not necessary to ensure the confidence of capital markets in LEC investments. The write off of assets is a frequent occurrence in competitive industries. Although investors would like social insurance funds to ensure them against the stranding of any investment, they understand the risks and rewards and do not require such funds for all

investment. These risk premiums have already been reflected in the handsome returns earned by incumbent local exchange companies.

The difference between embedded historical costs and the forward-looking, most efficient is made up of at least four components.

> (1) Excessive profits. Unjustifiably high profits have resulted from the inability of regulators to reduce rates of return and the institution of price cap regulation (which vastly under-estimated productivity gains), and a lack of competition for core services.
>
> (2) Strategic investments. Under regulation, the local companies have deployed capital assets in anticipation of movement into other businesses (e.g. video delivery and long distance service), the costs of which have been recovered in local service rates.
>
> (3) Inefficient costs. Unnecessarily high costs have resulted from decades of local franchise monopoly and have been perpetuated by the starting point of price indexing under price regulation.
>
> (4) Outmoded costs. Embedded costs associated with the pattern of investments that occur in a capital intensive industry with long-lived assets, uneven competition, and changing regulation could exceed theoretical forward-looking, long-run costs. The combination of an obligation to make certain investments, dramatically declining costs of providing service in an industry typified by lumpy investment, and regulatory changes may have left some assets which were prudently economic at one moment, no longer economically viable.

These costs would not be recovered in a competitive marketplace and should not be recovered under any reasonable theory of economic regulation.

- A persistent pattern of excess profits has existed for a decade.
- Similarly, consumer advocates have expressed continuing concern about the misallocation of over investment in the network to local rates and believe that these should be removed.
- Regulation was never intended to countenance inefficiency and the purpose of introducing competition is to eliminate it.

- Regulators never indemnified companies from technological obsolescence and have already compensated them for those risks.

Claims that these are opportunities which would be afforded companies in competitive markets are incorrect. Where decades of monopoly have created artificial scarcity, opportunity costs are meaningless. The difference between the net book historical cost and the so called market value is a function of franchise monopoly status, not economic efficiency. Whether it is the loop in telecommunications, the grid in electricity, or the pipe in natural gas, those capital assets were deployed subject to a franchise granted by the people and backed up by mandated scarcity. In the transition to competition, we must never forget that the fruits of this monopoly belong to ratepayers whose franchise created them and whose rates paid for them.

Where decades of monopoly power have existed, the availability of substitutes has been artificially restricted. Therefore the demand elasticities economists would use to place the heaviest burden on captive customers (Ramsey pricing) are distorted. In a prematurely deregulated context, these pricing rules simply transfer wealth from residential ratepayers to large business customers (by shifting the cost burden) and utility stockholders (because the restraint on excess profits is not operative). Wealth transfers typically exceed efficiency gains by a factor of four to one or more.

The weaknesses of Ramsey pricing are clear in other respects as well. As a theoretical proposition, the Ramsey pricing rule rests on an extreme and extensive set of assumptions which have virtually no chance of actually being met in reality and should not be applied in a competitive marketplace. As an empirical matter, the Ramsey pricing rule is intractable, since it requires data on demand elasticities which are not available. As a matter of public policy, the failure to meet theoretical assumptions and the weakness of the data mean that the Ramsey

pricing rule neither guarantees efficiency nor pro-competitive outcomes.

Moreover, any change in market share will be small and unfold over time. Those investors who are risk averse will have more than adequate time to dispose of their incumbent LEC holdings at prices far in excess of the book value of the assets that they own. If it becomes necessary to write off investment as so frequently happens in competitive industries, a new set of investors, more tolerant of risk and seeking potentially higher rewards, will enter the industry.

Competitors could be placed at a severe disadvantage as a result of the recovery of "stranded" investment. If the incumbent LECs are allowed to declare investment "stranded" whenever they lose customers and market share, they will be operating with a massive financial cushion. This will lower the risk that they face and continually reinforce their financial position. Competitors, who have no such cushion will be at a disadvantage.

3. Current Law Does Not Support the Claim for Revenue Replacement and Compensation for Stranded Investment

The claims of the LECs to revenue replacement and stranded investment rest on a version of the regulatory compact between stockholders and ratepayers that never existed. The guarantee of recovery that LECs claim is an ex post effort to recover assets and recoup actions for which management bears responsibility and stockholders have already been handsomely compensated.

To compensate companies for uneconomic investments, when they have already been compensated for the risk of those investments, constitutes a double recovery of costs which violates the fundamental principles of just and reasonable rates. Far from guaranteeing this complete recovery of all costs rendered uneconomic by competition, current law places the burden of the risk of competition squarely on the shoulders of utilities and shields them only

from the most dire financial outcome -- bankruptcy. The extremely strong financial performance of local exchange companies undermines any claims that failure to recover obsolete and uneconomic investment will threaten the financial soundness of these companies.

C. A RESPONSIBLE APPROACH TO STRANDED INVESTMENT

If the Commission decides that it should create a new form of regulatory treatment for investments that are likely to "stranded" as a result of changes in regulatory policy, it should do so with great care.

CFA and CU believe the Commission has an obligation to analyze the nature of this "stranded" investment before it allows recovery. This requires careful consideration of the circumstances under which investments were made and the extent to which management exercised choice in keeping assets on the books.

- Some investments may have been rendered obsolete in pursuit of marketing opportunities.
- Some investments may have been rendered obsolete as a result of technological progress, which the Commission certainly could not and never promised to control.
- Some investments may have gone bad because they were management mistakes.
- Some investments may have gone bad because they had bad luck.

None of these reasons for "stranded" investment have anything to do with the obligation to serve and CFA and CU maintain they should not be compensated as if they were a result of the obligation to serve. Competitive firms routinely write-down the value of assets for a variety of reasons, when they feel that they are under performing.

There has never been a guarantee of recovery of costs in the "social contract" between the company and the people, only an opportunity to earn a return commensurate with the risk incurred. Therefore, the key question is to separate out risks which the company incurred knowingly and for which it has been compensated from risks that it has not been compensated for, would not have taken but for the "social contract," and no longer believes it can be compensated for because of the alleged change in the terms of the "social contract."

There are two steps we believe the Commission could take to an estimate the previous compensation of risk, that prevent compensating the company twice, while also meeting the duty to compensate the company fairly.

First, if the Commission finds that the company's effort to split the ratebase entails an overrecovery of risk premiums, it must identify the risk premium. It could split the ratebase between social investment and (for lack of a better term) entrepreneurial investment (just as the company wants to do). The incumbent could be required to identify the specific assets which it claims were provided to meet its social obligation to serve which it now claims were undercompensated. The Commission could reconstruct the revenue stream (return of and on capital) that was associated with those assets. It could calculate the risk premium earned on those assets as the difference between the rate of return allowed on equity and on long term debt.

Some portion of this difference could be identified by the Commission as compensation for the risk of being "stranded." This could be deposited as a credit to the carrier of last resort account and drawn down before the company begins to collect its future carrier of last resort costs.